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How to slash the price of public borrowing

Ukraine is facing the problem of curtailing the price of public borrowing, which is higher than in Central European countries. The government considers decreasing the price of public borrowing to be a paramount objective of public debt management. Nevertheless, this objective cannot be considered disjointedly from the overall goals of the public debt policy. Ruslan Piontkivsky, ICPS senior economist, presented the survey results pertaining to this topic at a seminar on "The price of national borrowing for the government and ways of diminishing it"

Policy goals

The task of decreasing the price of the public debt should be resolved taking into account the overall policy of public borrowing. Policy goals in this domain are defined from the following viewpoints: (1) from the standpoint of the inter-temporal choice of the government, which maximises present and future public welfare; and (2) from the standpoint of developing the government securities market.

Correspondingly, the inter-temporal choice is expected to ensure:

• automatic stabilisation of the fiscal policy;

• crediting of investment activities;

• smoothing tax rates.

In the context of developing the state securities market, the government policy is focused on accomplishing the following goals:

• provide economic agents with additional financial instruments (and eventually the least risky ones);

• facilitate the usage of the market instrument of the monetary policy;

• boost the international credit rating of Ukraine, which acts as a general indicator for foreign investors.

Reducing the price

The key objective in the sphere of public debt management is meeting the financial needs of the government and the execution of its spending obligations at the lowest price in the mid- and long term, without exceeding a certain limit of risk. We accentuate the following crucial factors affecting the price of public borrowing:

• real interest rate. This indicator relies on economic performance; when productivity grows rapidly, the real interest rate is expected to be high;

• expected inflation. It should be remembered that it takes far more effort to reduce inflationary expectations than to raise them;

• risk premuim. The size of the premium often enlarges following a longer term of securities maturity due to aggravated uncertainty in the long term. Such uncertainty is primarily associated with the possibility of default, compulsory restructuring, higher inflation rate or depreciation, and changes in taxation.

We define the following ways to reduce the price of public borrowing :

• further reduction of the volume of borrowing;

• reduced risk premiums. The size of a premium can be reduced by performing current obligations and forming confidence in the economic policy, which will take much time;

• development of a secondary market for different types of state securities. A robust market will secure higher asset liquidity. Thus, economic agents will purchase state securities even at a lower return rate;

• diversification of financial instruments for different target groups (banks, non-banking financial institutions, enterprises, citizens, and non-residents). Such a policy will allow to more precisely single out the interests of different groups, some of which are ready to purchase government securities at a lower return rate;

• setting a forecasted inflation indicator, thanks to which inflation expectations of economic agents will stabilise (a gradual transition to inflation targeting strategy).

Reducing price vs. policy goals

It should be kept in mind that the public debt price cannot be the sole guideline and criterion for effectiveness. Dropping the price fits smoothly with the achievement of policy goals regarding public debt, which are determined in the context of inter-temporal choice made by the government. Nevertheless, the policy of reducing the price can contradict the objective of developing the state securities market. For example:

1. The price of borrowing can be curtailed by issuing only short-term securities, which offer a smaller risk premium. However, such conditions will not contribute to the development of the securities market by means of introducing long-term financial instruments.

2. The price of borrowing can be reduced through the diversification of financial instruments in accordance with the needs of different target groups. However, such a

How to restrict the impact of the public borrowing on the monetary policy

The public debt policy impacts the monetary policy. For example, increasing the public debt may have the following repercussions:

• raised interest rates in the economy;

• increased money supply, in case the debt is financed by the National Bank or non-residents (money supply does not alter if the debt is financed by the private sector).

At the same time, instruments employed by the monetary and fiscal policy will be effective only if they are independent. The sway of the fiscal policy over the monetary policy can be curbed through promoting development of the secondary securities market and shaping the confidence of potential clients. In this case, the government will attract money from the private sector, without altering monetary indicators. And the National Bank will conduct the monetary policy more vigorously by performing transactions in the secondary securities market.

move may worsen the liquidity of state securities, because small markets for each type of securities will emerge. Hence, the sale and purchase of securities will get more complicated. ■

The seminar "The price of public borrowing and ways of diminishing it" was held on 26 February 2002. The seminar was arranged by the Ministry of Economy and European Integration jointly with the Support for Economic and Fiscal Reform Project funded by the United States Agency for International Development (USAID).

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If prices move up, consumption of tobacco products will drop

Decreased consumption of tobacco products is one of the priority objectives of government policy on tobacco production. No policy can be effective without a proper analysis of factors that trigger demand for cigarettes. ICPS experts carried out an evaluation of the market of tobacco products, commissioned by the Alcohol and Drugs Information Centre. The experts endeavoured to determine the factors affecting the level of consumption of tobacco products in Ukraine

Demand factors

Based on the data of a sociological survey conducted last year throughout all regions in Ukraine,[1] we constructed a demand model for tobacco products, defining the major factors influencing consumption. Based on these factors, an effective policy targeted to curtail consumption volumes can be worked out. The following major factors shape demand for tobacco products:

- price;
- smoker's sex;
- smoker's age;
- income;
- residence area (based on the assumption that there are regional particularities of consumption).

Price impact on consumption

In order to trace to what extent the price for tobacco products affects consumption, we singled out age and income groups among Ukrainian smokers. Based on our research, we can maintain that price elasticity of demand depends on both consumers' age and income (see Table). Average price elasticity equals –0.4; that is, a 10% growth in price would push down the volume of consumption by 4%.

Specifically, this situation accentuates the fact that the youngest smokers are the most sensitive to price changes for tobacco products; meanwhile as they advance in years, price elasticity decreases. The lowest price elasticity is in the group of over-29-year-olds who earn high incomes.

Therefore, when launching a policy aimed at reducing the consumption volume of cigarettes, it should be noted that economic instruments (prices boosted by increased taxation) are most effective for the youngest smokers. In order to cut smoking among older people, additional measures should be applied (e.g., public campaigns, informing about the consequences of smoking for health, etc.)

Price elasticity of demand

	Low income	Average income	High income
14-17 yrs.	-0.65	-0.7	-0.52
18-28 yrs.	-0.37	-0.42	-0.24
Over 29 yrs.	-0.28	-0.33	-0.15

[1] An opinion poll conducted by the Ukrainian Institute of Social Studies and the Social Monitoring Centre, covering 2,721 respondents aged from 14 years.

Impact of other factors

We drew the following conclusions, based on our research:

- Demand for cigarettes will move upwards together with household incomes; namely, a 10% increase in incomes triggers 0.6% of demand growth. Therefore, when piloting a policy aimed at restricting consumption, the current trend for Ukrainians' income growth should be taken into account.
- On average, women smoke 16% fewer cigarettes than men. Thus, men should be the primary target of public campaigns and instructive measures;
- A different level of consumption is traced across different regions. The biggest daily amount of cigarettes is consumed in southern regions of Ukraine. Other regions smoke less cigarettes than in the south; 14% less in the west, 10% less in central Ukraine, 15% less in the north, and 13% less in the east. Thus, such regional differences should not be disregarded, and special attention should be paid to those regions where consumption is the highest.■

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ICPS experts executed the following studies of public policy in the sphere of tobacco production:

- *"Analysis of implications following the implementation of the mixed system of excise on tobacco products". 2002. Client: JT International Company Ukraine (for the Ukrainian version of the survey report see our web-site at: www.icps.kiev.ua/docs/other/tobacco_excise_ukr.pdf);*
- *"Analysis of the market and taxation of tobacco products". 2001. Client: Alcohol and Drugs Information Centre (ADIC). The results of the ICPS survey were included in the ADIC report "The economics of controling tobacco in Ukraine from the standpoint of public health" (www.adic.org.ua);*
- *"Determining the optimal excise rate: example of Ukraine's tobacco industry." 2001. The survey report can be found at: www.icps.kiev.ua/docs/other/tobacco_max_eng.doc;*
- *"Causes and effects of the illegal import and circulation of tobacco products in Ukraine." 2000. Client: Coalition for the Protection of Intellectual Property Rights (the text of the survey report is located at: www.icps.kiev.ua/docs/other/contraband_eng.pdf).*

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